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The Mystery of Capital

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Why has the genesis of capital become such a mystery? And why have the rich nations of the world not explained to other nations how indispensable a formal property system is to capital formation?

Walk down most roads in the Middle East, the former Soviet Union, or Latin America, and you will see many things: houses used for shelter; parcels of land being tilled, sowed, and harvested; merchandise being bought and sold. Assets in developing and former communist countries primarily serve these immediate physical purposes. In the West, however, the same assets also lead a parallel life as capital outside the physical world. They can be used to put in motion more production by securing the interests of other parties as "collateral" for a mortgage, for example, or by assuring the supply of other forms of credit and public utilities.

Why can't buildings and land elsewhere in the world also lead this parallel life? Why can't the enormous resources in developing and former communist countries, which my colleagues at the Institute for Liberty and Democracy (Lima) and I estimate at $9.3 trillion of dead capital, produce value beyond their "natural" state? My reply is, dead capital exists because we have forgotten (or perhaps never realized) that converting a physical asset to generate capital—using your house to borrow money to finance an enterprise, for example—requires a very complex process. It is not unlike the process that Albert Einstein taught us whereby a single brick can be made to release a huge amount of energy in the form of an atomic explosion. By analogy, capital is the result of discovering and unleashing potential energy from the trillions of bricks that the poor have accumulated in their buildings.

Clues from the past

To unravel the mystery of capital, we have to go back to the seminal meaning of the word. In medieval Latin, "capital" appears to have denoted head of cattle or other livestock, which have always been important sources of wealth beyond the basic meat, milk, hides, wool, and fuel they provide. Livestock can also reproduce themselves. Thus, the term "capital" begins to do two jobs simultaneously, capturing the physical dimension of assets (livestock) as well as their potential to generate surplus value. From the barnyard, it was only a short step to the desks of the inventors of economics, who generally defined "capital" as that part of a country's assets that initiates surplus production and increases productivity.

Great classical economists such as Adam Smith and, later, Karl Marx believed that capital was the engine that powered the market economy. In *The Wealth of Nations*, Smith emphasized one point that is at the very heart of the mystery we are trying to solve: for accumulated assets to become active capital and put additional production in motion, they must be *fixed and realized in some particular subject* "which lasts for some time at least after that labour is past. It is, as it were, a certain quantity of labour stocked and stored up to be employed, if necessary, upon some other occasion." What I take from Smith is that capital is not the accumulated stock of assets but the *potential* it holds to deploy new production. This potential is, of course, abstract. It must be processed and fixed into a tangible form before we can release it—just like the potential nuclear energy in Einstein's brick.

This essential meaning of capital has been lost to history. Capital is now confused with money, which is only one of the many forms in which it travels. It is always easier to remember a difficult concept in one of its tangible manifestations than in its essence. The mind wraps itself around "money" more easily than "capital." But it is a mistake to assume that money is what finally fixes capital. Money facilitates transactions, allowing us to buy and sell things, but it is not itself the progenitor of additional production.

Potential energy in assets

What is it that fixes the potential of an asset so that it can put additional production into motion? What detaches value from a simple house and fixes it in a way that allows us to realize it as capital?

We can begin to find an answer by using our energy analogy. Consider a mountain lake. We can think about this lake in its immediate physical context and see some primary uses for it, such as canoeing and fishing. But when we think about this same lake as an engineer would by focusing on its capacity to generate electrical energy, by means of a hydroelectric plant, as an additional value beyond the lake's natural state as a body of water, we suddenly see the potential created by the lake's elevated position. The challenge for the engineer is finding out how he can create a *process* that allows him to convert and fix this potential into a form that can be used to do additional work.

Capital, like energy, is a dormant value. Bringing it to life requires us to go beyond *looking* at our assets as they are to actively *thinking* about them as they could be. It requires a process for fixing an asset's economic potential into a form that can be used to initiate additional production.

Although the process that converts the potential energy in the water into electricity is well known, the one that gives assets the form required to put in motion more production is not known. This is so because that key process was not deliberately set up to create capital but for the more mundane purpose of protecting property ownership. As the property systems of Western nations grew, they developed, imperceptibly, a variety of mechanisms that gradually combined into a process that churned out capital as never before.

Hidden conversion process of the West

In the West, this formal property system begins to process assets into capital by describing and organizing the most economically and socially useful aspects about assets, preserving this information in a recording system—as insertions in a written ledger or a blip on a computer disk—and then embodying it in a title. A set of detailed and precise legal rules governs this entire process. Formal property records and titles thus represent our shared concept of what is economically meaningful about any asset. They capture and organize all the relevant information required to conceptualize the potential value of an asset and so allow us to control it.

Any asset whose economic and social aspects are not fixed in a formal property system is extremely hard to move in the market. How can the huge amounts of assets changing hands in a modern market economy be controlled, if not through a formal property process? Without such a system, any trade of an asset, say a piece of real estate, requires an enormous effort just to determine the basics of the transaction: Does the seller own the real estate and have the right to transfer it? Can he pledge it? Will the new owner be accepted as such by those who enforce property rights? What are the effective means to exclude other claimants? This is why the exchange of most assets outside the West is restricted to local circles of trading partners.

Developing and former communist countries' principal problem is clearly not the lack of entrepreneurship: the poor have accumulated trillions of dollars of real estate during the past forty years. What the poor lack is easy access to the property mechanisms that could legally fix the economic potential of their assets so that they could be used to produce, secure, or guarantee greater value in the expanded market.

Why has the genesis of capital become such a mystery? Why have the rich nations of the world, so quick with their economic advice, not explained how indispensable formal property is to capital formation? The answer is that the process within the formal property system that breaks down assets into capital is extremely difficult to visualize. It is hidden in thousands of pieces of legislation, statutes, regulations, and institutions that govern the system. Anyone trapped in such a legal morass would be hard-pressed to figure out how the system actually works. The only way to see it is from outside the system—from the extralegal sector—which is where my colleagues and I do most of our research.

The formal property systems of the West produce six effects that allow their citizens to generate capital.

(1) Fixing the economic potential of assets. Capital is born by representing in writing—in a title, a security, a contract, and other such records—the most economically and socially useful qualities *about* the asset as opposed to the visually more striking aspects of the asset. This is where potential value is first described and registered. The moment you focus your attention on the title of a house, for example, and not on the house itself, you have automatically stepped from the material world into the conceptual universe where capital lives.

The proof that formal property is pure concept comes when a house changes hands: nothing physically changes. Property is not the house itself but an economic concept *about* the house, embodied in a legal representation that describes not its physical qualities but rather economically and socially meaningful qualities we humans have attributed to the house (such as the ability to use it for a variety of purposes—for example, to generate funds for investment in a business without having to sell the house—by providing security to lenders in the form of liens, mortgages, easements, or other covenants). In advanced nations, this formal property representation functions as the means to secure the interests of other parties and to create accountability by providing all the information, references, rules, and enforcement mechanisms required to do so.

Legal property thus gave the West the tools to produce surplus value over and above its physical assets. Whether anyone intended it or not, the legal property system became the staircase that took these nations from the universe of assets in their natural state to the conceptual universe of capital where assets can be viewed in their full productive potential.

(2) Integrating dispersed information into one system. The reason capitalism has triumphed in the West and sputtered in the rest of the world is because most of the assets in Western nations have been integrated into one formal representational system. This integration did not happen casually. Over decades in the nineteenth century, politicians, legislators, and judges pulled together the scattered facts and rules that had governed property throughout cities, villages, buildings, and farms and integrated them into one system. This "pulling together" of property representations, a revolutionary moment in the history of developed nations, deposited all the information and rules governing the accumulated wealth of their citizens into one knowledge base. Before that moment, information about assets was far less accessible. Every farm or settlement recorded its assets and the rules governing them in rudimentary ledgers, symbols, or oral testimony. But the information was atomized, dispersed, and not available to any one agent at any given moment.

Developing and former communist nations have not created unified formal property systems. In all of these countries I have studied, I have never found just one legal system but instead dozens and hundreds, managed by all sorts of organizations, some legal, others extralegal, ranging from small entrepreneurial groups to housing organizations. Consequently, what people in those countries can do with their property is limited to the imagination of the owners and their acquaintances. In Western countries, where property information is standardized and universally available, what owners can do with their assets benefits from the collective imagination of a larger network of people.

It may surprise the Western reader that most of the world's nations have yet to integrate extralegal property agreements into one formal legal system. For Westerners today, there supposedly is only one law—the official one. Diverse informal property arrangements, however, were once the norm in every nation—the West's reliance on integrated property systems is a phenomenon of at most the last two hundred years. The reason it is so hard to follow the history of the integration of widespread property systems is that the process took place over a very long time.

(3) Making people accountable. The integration of all property systems under one formal property law shifted the legitimacy of the rights of owners from the political context of local communities to the impersonal context of law. Releasing owners from restrictive local arrangements and bringing them into a more integrated legal system facilitated their accountability.

By transforming people with real property interests into accountable individuals, formal property created individuals from masses. People no longer needed to rely on neighborhood relationships or make local arrangements to protect their rights to assets. They were thus freed to explore how to generate surplus value from their own assets. But there was a price to pay: once inside a formal property system, owners lost their anonymity while their individual accountability was reinforced. People who do not pay for goods or services they have consumed can be identified, charged interest penalties, fined, and embargoed, and can have their credit ratings downgraded. Authorities are able to learn about legal infractions and dishonored contracts; they can suspend services, place liens against property, and withdraw some or all of the privileges of legal property.

Respect in Western nations for property and transactions is hardly encoded in their citizens' DNA; it is rather the result of having enforceable formal property systems. Formal property's role in protecting not only ownership but also the security of transactions strongly encourages citizens in advanced countries to respect titles, honor contracts, and obey the law. Legal property thus invites commitment.

The lack of legal property thus explains why citizens in developing and former communist nations cannot make profitable contracts with strangers and cannot get credit, insurance, or utilities services: they have no property to lose. Because they have no legal property, they are taken seriously as contracting parties only by their immediate family and neighbors. People with nothing to lose are trapped in the grubby basement of the precapitalist world.

(4) Making assets fungible. One of the most important things a formal property system does is transform assets from a less accessible condition to a more accessible condition, so that they can do additional work. Unlike physical assets, representations of assets are easily combined, divided, mobilized, and used to stimulate business deals. By uncoupling the economic features of an asset from its rigid, physical state, a representation makes the asset "fungible"—able to be fashioned to suit practically any transaction.

By describing all assets in standard categories, an integrated formal property system enables the comparison of two architecturally different buildings constructed for the same purpose. This allows one to discriminate quickly and inexpensively between similarities and differences in assets without having to deal with each asset as if it were unique.

Standard property descriptions in the West are also written to facilitate the combination of assets. Formal property rules require assets to be described and characterized in a way that not only outlines their singularities but also points out their similarities to other assets, thus making potential combinations more obvious. Through the use of standardized records, one can determine how to exploit a particular asset most profitably.

Representations also enable one to divide assets without touching them. Whereas an asset such as a factory may be an indivisible unit in the real world, in the conceptual universe of formal property representation it can be subdivided into any number of portions. Citizens of advanced nations are thus able to split most of their assets into shares, each of which can be owned by different persons, with different rights, to carry out different functions.

Formal property representations can also serve as movable stand-ins for physical assets, enabling owners and entrepreneurs to simulate hypothetical situations in order to explore other profitable uses of their assets. In addition, all standard formal property documents are crafted in such a way as to facilitate the easy measurement of an asset's attributes. By providing standards, Western formal property systems have significantly reduced the transaction costs of mobilizing and using assets.

(5) Networking people. By making assets fungible, by attaching owners to assets, assets to addresses, and ownership to enforcement, and by making information on the history of assets and owners easily accessible, formal property systems converted the citizens of the West into a network of individually identifiable and accountable business agents. The formal property process created a whole infrastructure of connecting devices that, like a railway switchyard, allowed the assets (trains) to run safely between people (stations). Formal property's contribution to mankind is not the protection of ownership: squatters, housing organizations, mafias, and even primitive tribes manage to protect their assets quite efficiently. The property system's real breakthrough is that it radically improved the flow of communications about assets and their potential. It also enhanced the status of their owners.

Western legal property also provides businesses with information about assets and their owners, verifiable addresses, and objective records of property values, all of which lead to credit records. This information and the existence of integrated law make risk more manageable by spreading it through insurance-type devices as well as by pooling property to secure debts.

Few seem to have noticed that the legal property system of an advanced nation is the center of a complex web of connections that equips ordinary citizens to form ties with both the government and the private sector, and so to obtain additional goods and services. Without the tools of formal property, it is hard to see how assets could be used for everything they accomplish in the West.

(6) Protecting transactions. One important reason why the Western formal property system works like a network is that all the property records (titles, deeds, securities, and contracts that describe the economically significant aspects of assets) are continually tracked and protected as they travel through time and space. Public agencies are the stewards of an advanced nation's representations. They administer the files that contain all the economically useful descriptions of assets, whether land, buildings, chattels, ships, industries, mines, or airplanes. These files will alert anyone eager to use an asset about things that may restrict or enhance its utilization, such as encumbrances, easements, leases, arrears, bankruptcies, or mortgages. In addition to public record-keeping systems, many other private

services (escrow and closing organizations, appraisers, etc.) have evolved to assist parties in fixing, moving, and tracking representations so they can easily and securely produce surplus value.

Although they are established to protect the security of both ownership and transactions, it is obvious that Western systems emphasize the latter. Security is principally focused on producing trust in transactions so that people can more easily make their assets lead a parallel life as capital. The Western emphasis on the security of transactions allows citizens to move large amounts of assets with very few transactions. In most developing countries, by contrast, the law and official agencies are trapped by early colonial and Roman law, which tilt toward protecting ownership. They have become the custodians of the wishes of the dead.

Conclusion

Much of the marginalization of the poor in developing and former communist nations comes from their inability to benefit from the six effects that formal property provides. The challenge these countries face is not whether they should produce or receive more money but whether they can understand the legal institutions and summon the political will necessary to build a property system that is easily accessible to the poor.

The French historian Fernand Braudel found it a great mystery that at the inception of Western capitalism, it served only a privileged few, just as it does elsewhere in the world today:

> The key problem is to find out why that sector of society of the past, which I would not hesitate to call capitalist, should have lived as if in a bell jar, cut off from the rest; why was it not able to expand and conquer the whole of society? . . . [Why was it that] a significant rate of capital formation was possible only in certain sectors and not in the whole market economy of the time?

I believe the answer to Braudel's question lies in restricted access to formal property, both in the West's past and in developing and former communist countries today. Local and foreign investors do have capital; their assets are more or less integrated, fungible, networked, and protected by formal property systems. But they are only a tiny minority—those who can afford the expert lawyers, insider connections, and patience required to navigate the red tape of their property systems. The great majority of people, who cannot get the fruits of their labor represented by the formal property system, live outside Braudel's bell jar.

The bell jar makes capitalism a private club, open only to a privileged few, and enrages the billions standing outside looking in. This capitalist apartheid will inevitably continue until we all come to terms with the critical flaw in many countries' legal and political systems that prevents the majority from entering the formal property system.

The time is right to find out why most countries have not been able to create open formal property systems. This is the moment, as Third World and former communist nations are living through their most ambitious attempts to implement capitalist systems, to lift the bell jar.

This article is derived from Chapter 3 of the author's book, The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else *(New York: Basic Books and London: Bantam Press/Random House, 2000).*

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